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Western Europe: Coping With the Dollar [redacted] 25X1

An Intelligence Assessment

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EUR 85-10100
June 1985

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An Intelligence Assessment

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This paper was prepared by Office of European Analysis; of the Office of European Analysis and of the Analytic Support Group provided the econometric simulations. Comments and queries are welcome and may be directed to European Issues Division, EURA,

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Scope Note

This Intelligence Assessment analyzes how the appreciation of the dollar over the past few years has affected the West European economies. It also looks at the economic and political consequences for the West European countries of future movements—both up and down—in the dollar's exchange rate as well as implications for US foreign policy. We do not attempt to forecast future movements of the dollar.

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Western Europe: Coping With the Dollar

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Key Judgments

Information available as of 1 May 1985 was used in this report.

The growing strength of the dollar over the past few years has been a major factor contributing to the West European economic recovery. Primarily because of the 67-percent real appreciation of the dollar against the European Currency Unit between 1980 and 1984, Western Europe increased its exports to the United States and OPEC and reduced its imports of dollar-denominated products such as US-produced goods, oil, and many raw materials. As a result of trade-related effects from dollar appreciation, our econometric model shows that the level of real GNP in the four major West European countries was 4 percent higher in 1984 than it would have been if exchange rates had only changed according to the differences in inflation rates. Although the strong dollar generated additional pressure on West European prices, all the major West European countries lowered their inflation rates during the period. Moreover, the rising dollar has helped stabilize the European Monetary System (EMS) by holding down the West German mark against the other EMS currencies.

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Net capital flows from Western Europe to the United States—a major factor causing the dollar's rise—have negatively affected the West European economies, but not enough to offset the trade advantage from a stronger dollar. The reduction in the supply of capital in Western Europe created upward pressure on interest rates, which cut investment and—to a lesser extent—consumption. However, even if we make the extreme assumption that capital outflows, induced in part by high US interest rates, caused all of the actual rise in West European real interest rates during the 1980-84 period, less than half of the dollar's positive impact on GNP would be eliminated. In fact, anti-inflationary monetary policies in the region almost certainly were at least as important a factor boosting interest rates in Western Europe as US monetary developments.

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Future movements of the dollar—up or down—are certain to evoke new criticism of US economic policy. We believe that US–West European relations, as well as relations among the West Europeans, would face many more problems if the dollar depreciates. In that case, and particularly if the dollar weakens rapidly:

- West European economic growth would be held down by worsening trade competitiveness.
- Reduced international competitiveness would also lead to increased protectionist pressures.
- Another EMS crisis probably would occur because capital leaving the United States almost certainly would flow more into West Germany than into France, thus pushing up the mark against the franc.

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The impact of a falling dollar, however, would not be wholly negative. Downward pressure on the dollar would permit the West Europeans to reduce interest rates and also would enable them to increase real expenditures on defense without spending more in their national currencies. Over the past several years, the appreciating dollar has impaired the defense capabilities of West European NATO members by reducing the purchasing power of defense budgets for petroleum—which is priced in dollars and is needed for operations and training—and for procuring US military hardware.

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If the dollar grows even stronger, West European defense spending plans would be more expensive, but other US–West European relations need be little affected. We believe that most West European governments would maintain their present economic policies in the face of a strong dollar, although they would complain about the inflationary impact on their economies and worry about a buildup in protectionist pressures in the United States. As long as West European governments do not boost interest rates to reverse capital flows to the United States, Western Europe would continue to reap the growth benefits of a less competitive US economy.

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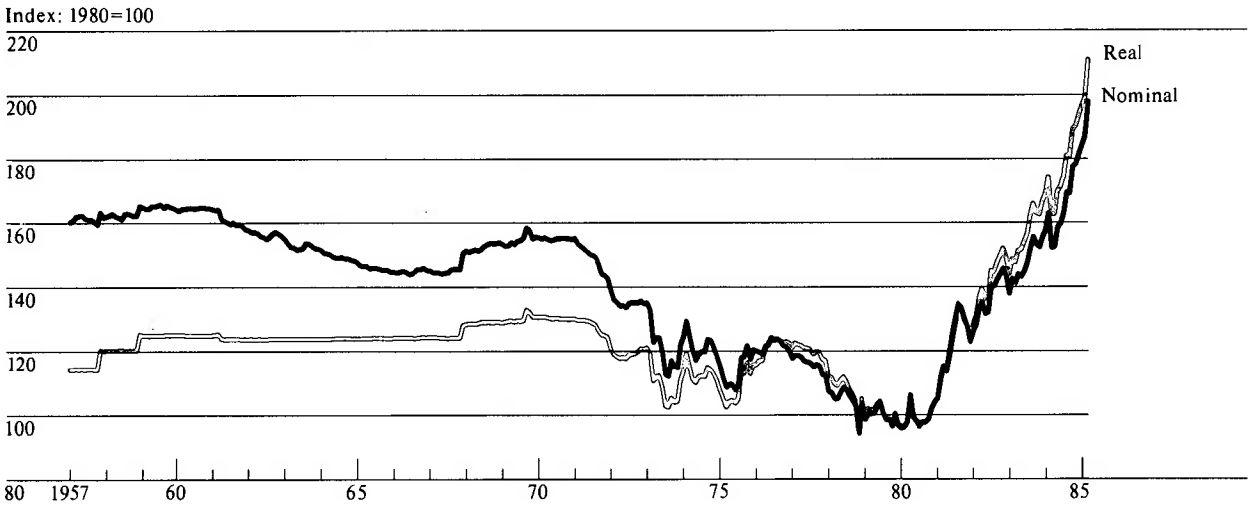
Figure 1
US Dollar: Change Against the European Currency Unit, 1957-85



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Western Europe: Coping With the Dollar

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Introduction

The US dollar has swung widely in value—particularly against West European currencies—since the Bretton Woods system of fixed exchange rates collapsed in 1971 (see inset). After falling 20 percent in nominal terms against the European Currency Unit (ECU) during 1976-80, the dollar shot up almost 80 percent between 1980 and 1984 (see inset on page 2).[1] In real (inflation-adjusted) terms, the dollar's rise against the ECU has been only slightly less spectacular: 67 percent between 1980 and 1984 (see figure 1).

For much of the 1980-83 period, and again in recent months, West European leaders complained vociferously about the growing strength of the dollar. Most argued that the strong dollar was putting upward pressure on interest rates, holding back economic growth, and boosting inflation by raising the cost of dollar-denominated commodities—especially oil. French Prime Minister Pierre Mauroy even attributed the failure of the original Mitterrand economic program to the dollar's rise.

Ironically, five years ago the West Europeans were complaining about the dollar's weakness. During the 1980 Economic Summit in Venice, West European leaders criticized the fall in the dollar's value for destabilizing the world economy. Then West German Chancellor Schmidt, for example, claimed that the failure of US authorities to adopt policies to stabilize the dollar encouraged OPEC members to hike oil prices further to maintain their purchasing power and thus threatened to deepen the recession and increase inflation.

Recent Reactions to the Strong Dollar

Between mid-1983 and late 1984, West European criticism of the dollar abated—perhaps because of a growing awareness that a strong dollar confers benefits as well as problems. West German Chancellor Kohl and French President Mitterrand during their state visits to the United States before the London Summit did not dwell on the "dollar problem" as they had at the Williamsburg Summit. At the London Summit in June 1984, the West European leaders concentrated much more on the impact on their economies of continuing high US interest rates. Even

Why Exchange Rates Change

The dollar's exchange rate, like those of other convertible currencies, is determined by supply and demand in the foreign exchange market. Everything else being equal, the value of a country's currency is pushed down when the country runs a current account deficit—a deficit in trade of goods and services and private transfer payments—because the country is selling more of its currency (to pay for imports) than foreigners want to buy (to pay for exports) at the current exchange rate. Capital flows, however, can either reinforce or counterbalance the impact of the current account. In the case of the United States since 1982, the dollar has appreciated despite large current account deficits because people wanted to buy more dollar-denominated assets than foreign-currency-denominated assets.

Whereas income, tastes, and relative prices of goods and services affect trade, other factors determine the direction of capital flows:

- *Interest rate differentials.*
- *Differentials in the expected rates of return on non-interest bearing assets.*
- *Expectations for exchange rate changes.*
- *Political conditions.*

All these factors involve comparisons among countries, and any combination can affect exchange rates. If a currency such as the dollar is widely held as a store of value, the importance of capital flows in determining exchange rates is magnified.

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[1] Although the ECU was not created until 1979, we have used it for earlier periods to measure US dollar movements against the EC currencies.

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Structure of the European Monetary System

The European Monetary System (EMS) is basically a joint float of eight EC currencies;[a] the United Kingdom and Greece do not participate although their currencies are included in calculating the European Currency Unit (ECU). The system's prime objective is stabilizing the value of the members' currencies against one another. The Community hopes that the existence of the EMS will prod member countries to coordinate their economic policies. Economic convergence would then allow the Community to establish a centralized monetary authority, furthering the goal of eventual economic and monetary union.

At the heart of the EMS is the ECU, an accounting unit made up of a basket of the 10 EC currencies.[b] In exchange for 25 billion ECUs, the central banks of the eight EMS countries allotted 20 percent of their foreign exchange and gold reserves to the European Monetary Cooperation Fund (FECOM). The Fund primarily acts as a clearinghouse for swap transactions between members' central banks. The FECOM also manages short-term loans of reserves to the member countries.

The EMS joint float is a "parity grid" set up so that each currency may deviate from its parity against any other currency by no more than 2.25 percent (6 percent for the Italian lira). Action is required if a currency reaches its limit on the grid. At that point, the EMS central banks are expected to intervene in the foreign exchange market to maintain the integrity of the band. Realignments of the central rates occur when the member countries unanimously agree that the old parities can no longer be maintained.

To signal potential problems, the EMS also uses a "divergence indicator," which is calculated as a deviation from each currency's central rate against the ECU. If a currency's exchange rate goes past the divergence indicator, the EMS countries "presume" that the country with the diverging currency will take appropriate action, such as adjusting its monetary or fiscal policies. Although action is not required, the government must explain to the other EMS countries why it chooses not to act.

[a] Belgium and Luxembourg maintain a monetary union, with both currencies equal in value; thus, the Luxembourg franc does not float separately.

[b] The ECU is made up of 0.719 West German mark, 1.31 french frances, 0.0878 British pound, 140 Italian Lire, 0.256 Dutch guilder, 3.71 Belgian francs, 0.219 Danish krone, 1.15 Greek drachmas, 0.00871 Irish punt, and 0.14 Luxembourg franc.

when the dollar breached the three-mark and the nine-franc levels in early September 1984, West European officials were conspicuously silent.

During 1984, the West Europeans clearly became more aware of the boost that the strong dollar—and robust US economy—was giving to their exports and their economic growth rates, an important consideration in view of their growing unemployment problem. In its mid-1984 economic review, the West German Institute for Economic Research (DIW)—for example—attributed the West German recovery mainly to an export boom powered by US economic growth and the strength of the dollar. Following a 9-percent gain in 1983, the value of West European exports to the United States soared 25 percent last year, topping the $60 billion mark. In 1984, West German and French exports to the United States rose 30 percent to $16.5 billion and $7.9 billion, respectively, while Italian sales increased 37 percent to $7.5 billion. British exports of manufactures also soared, although a decline in precious metal sales held the growth of total exports to the United States to 14 percent. With imports from the United States up only 3 percent last year, Western Europe recorded a $5 billion bilateral trade surplus compared with a $30 billion deficit in 1980.

Realization that the strong dollar has contributed to EMS stability probably also has played a major role in dampening West European criticism. The EMS has now gone two years without experiencing one of the

Table 1
World: Foreign-Owned Bank Accounts by Currency [a]

Billion US $

	Dec 1980	Dec 1981	Dec 1982	Dec 1983	Sep 1984
US dollars	647.9	768.8	801.5	851.7	869.9
Other	265.8	277.9	268.6	270.6	264.7
Of which:					
West German marks	128.7	121.5	116.3	113.8	110.8
Swiss francs	56.5	72.6	62.2	63.9	60.8
Japanese yen	11.2	16.1	16.9	21.7	21.4
British pounds	24.4	19.9	16.2	14.6	16.1
French francs	14.7	11.4	11.3	11.4	10.7
Netherlands guilders	8.4	9.3	10.8	11.5	11.3
European Currency Units	NA	NA	NA	7.0	13.0

[a] External liabilities of banks reporting to the Bank for International Settlements.

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bitter realignment struggles that previously had occurred, on average, every nine months. In contrast with the earlier pattern after an EMS realignment, the West German mark has not experienced great upward pressure against the French franc or the Italian lira despite West Germany's lower inflation rate and stronger current account balance. As a store of value, the mark is often held as a substitute for the dollar (see table 1). When the dollar started rising, people sold their marks for dollars faster than they sold French francs or Italian lire, holding the mark down within the EMS (see figure 2). At one point when the dollar began to slip temporarily in early 1984, the traditional pattern of the mark gaining on the franc reemerged but did not progress enough for an EMS realignment before the dollar rebounded.

In the last few months, however, West European concern over the strong dollar has picked up again. This shift does not appear to result from a reevaluation of the dollar's impact on Western Europe. It stems in part, rather, from political considerations in a region where weak currencies are often taken as an indication of government failure. In the United Kingdom, for example, Prime Minister Thatcher has said that the value of a nation's currency reflects its basic strength and that the pound should remain above parity with the dollar. The major reason for the increased concern, however, probably is the widespread feeling that a stronger dollar now means a sharper fall in the dollar later—the exchange rate development the West Europeans fear most. Although the strong dollar was not a major issue at the Bonn Summit, concern about the dollar's wide fluctuation in value has been the main factor behind French demands for an international monetary conference.

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The Monetary Policy Reaction

One reason the West Europeans became less concerned last year about the strength of the dollar was because of their apparent decision to "decouple" their economic policies from changes in the dollar. By decoupling—a term coined by the EC Commission—the West Europeans mean that they would take no significant action to bolster their currencies against a rising dollar but would ease monetary policy as the

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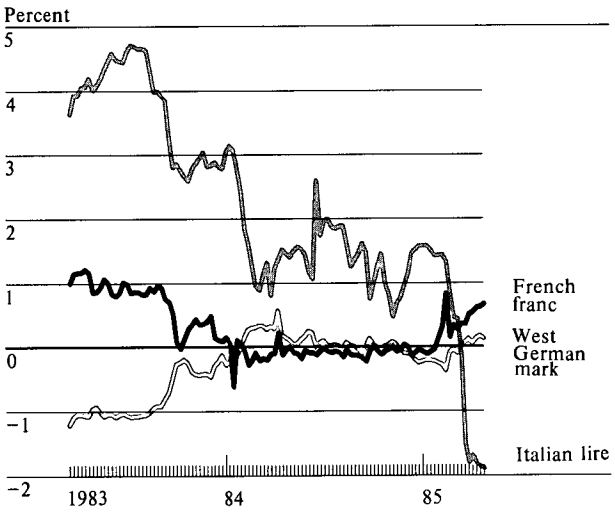
Figure
European Monetary System: Divergence From ECU Parity, 1983-85[a]



[a] Weekly data beginning 22 March 1983.

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dollar weakens. Increasingly the West Europeans believe that effective countermeasures to the rise of the dollar probably would cost their economies more than the potential gains. Italian Senator Guido Carli, a former governor of the Banca d'Italia, wrote last July that the decoupling of the EMS currencies from US monetary policy had insulated Western Europe from most of the negative effects of the dollar's rise. In the same month Bundesbank officials were quoted in the press as saying that boosting West German interest rates to strengthen the mark against the dollar would be an "overreaction."

The West Europeans are still concentrating mainly on maintaining stable exchange rates among their own currencies while pursuing economic recovery.

The West Europeans clearly would like to halt the dollar's rise—as shown by their coordinated intervention in the exchange markets in February 1985—but feel they lack the means short of boosting interest rates to completely unacceptable levels. The major exception is the United Kingdom, where Prime Minister Thatcher is constrained by her commitment to keep sterling above parity with the dollar. Even here, however, the decision in January to increase bank lending rates sharply appears to have been tied, at least in part, to the pound's fall against other West European currencies, not just against the dollar. Bonn's boosting of the Lombard rate in February apparently was a reaction to internal developments rather than an attempt to strengthen the mark. 25X1

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Evidence suggests that the West Europeans have in fact weakened the links between US and West European interest rates. Although US and West European real interest rates are both higher than they were in the 1970s, changes in their respective levels are much less closely correlated than they were then; this is true for both long- and short-term rates. Specifically, the statistical correlation between US real rates and West German and British real rates since 1980 is only one-fourth as strong as it was during 1971-80, while the link between US and French rates is one-half as strong; our data shows that Italian real interest rates have never been much affected by US rates. 25X1 25X1

Impact of the Strong Dollar

Although the appreciation of the dollar during 1980-84 on balance helped the West European economies, most attention initially was focused on the negative effects. In particular, the rising dollar increased the prices that Western Europe had to pay for oil and other dollar-denominated commodities. Moreover, the capital outflows that were pushing up the dollar reduced the supply of loanable funds, thereby causing West European interest rates to be higher than they otherwise might have been. The depreciation of Western Europe's currencies against the dollar, however, trimmed their imports and gradually stimulated exports; when coupled with the strong US recovery, the region's growth began to pick up. Moreover, fears that 25X1 25X1 25X1

increases in LDC debt service due to the rise in the dollar would reduce LDC purchases from Western Europe have proved ill founded; most import cutbacks by the LDCs have come at the expense of the United States.

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Using the CIA's Linked Policy Impact Model (LPIM), we estimate that the effect of the dollar's appreciation since 1980 was to raise the level of Big Four GNP in 1984 almost 4 percent above the level that would have existed if real exchange rates had been constant (see table 2 and inset). Not surprisingly, the main positive impact came in the foreign sector where real exports of goods and services last year were 2.6 percent higher than in the baseline scenario, while imports were 4 percent lower. This improvement in net foreign demand alone counted for over half of the 4-percent increase in GNP. Our results also indicate that the strong dollar has boosted West European investment and private consumption—by 3.6 percent and 1.9 percent, respectively, as compared with the levels that otherwise would have existed. At the same time, our model indicates that the average price level in the Big Four was, by 1984, 11 percent higher than it otherwise would have been.

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Within the Big Four, results were broadly similar except that Italy clearly benefited least from the strong dollar. All four countries received a significant boost to their foreign sectors and all except Italy also got a boost to domestic consumption and investment. Italy also absorbed by far the largest inflationary impact of the strong dollar, reflecting its unusually heavy dependence on imported energy, while France incurred the smallest impact on its domestic prices.

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These results somewhat overstate the positive impact of the dollar because the negative impact of net capital flows from Western Europe to the United States is not explicitly captured in our model. In 1981 net capital flows from the United States to Western Europe amounted to $14.5 billion; just two years later, the reversed net flow totaled $28.9 billion. The net flow of capital from Western Europe to the United States continued in 1984 and for the first three quarters of the year amounted to $17.1 billion.

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Table 2
Big Four: Impact of the 1980-84 Real Appreciation of the US Dollar

Percent change from baseline simulation

	1981	1982	1983	1984
Big Four				
GNP	0.3	1.2	2.1	3.9
Private consumption	−0.8	−0.5	0.4	1.9
Investment	0.1	1.5	2.1	3.6
Exports of goods and services	0.6	0.5	0.6	2.6
Imports of goods and services	−2.1	−3.7	−4.5	−4.0
Price level (GNP deflator)	0.9	3.7	7.0	11.0
West Germany				
GNP	0.4	1.3	2.6	4.8
Private consumption	−0.3	0.2	2.0	5.0
Investment	0.9	2.4	3.9	6.1
Exports of goods and services	0.3	NEGL	NEGL	1.8
Imports of goods and services	−1.2	−2.3	−2.4	−0.4
Price level(GNP deflator)	0.8	3.9	7.4	11.9
France				
GNP	0.3	1.7	2.4	4.4
Private consumption	−0.4	−0.3	0.1	1.0
Investment	0.9	3.2	5.5	4.5
Exports of goods and services	1.2	1.0	0.8	2.7
Imports of goods and services	−3.2	−3.0	−3.4	−3.8
Price level (GNP deflator)	0.3	1.3	3.0	4.9
United Kingdom				
GNP	0.7	1.7	2.6	3.4
Private consumption	−1.2	−0.2	0.3	0.5
Investment	0.9	3.2	5.5	4.5
Exports of goods and services	1.2	1.0	0.8	2.7
Imports of goods and services	−3.2	−3.0	−3.4	−3.8
Price level (GNP deflator)	0.7	2.9	5.3	7.5
Italy				
GNP	−0.5	−0.6	−0.3	1.3
Private consumption	−1.8	−3.0	−3.1	−2.2
Investment	−0.7	−2.1	−2.8	−1.1
Exports of goods and services	0.7	0.9	1.3	3.5
Imports of goods and services	−2.6	−6.2	−7.6	−7.5
Price level (GNP deflator)	2.2	8.1	15.1	23.5

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Methodology for Estimating the Impact of the Dollar's Strength

The Linked Policy Impact Model (LPIM) integrates individual 200-equation econometric models of the seven major industrial economies—West Germany, France, the United Kingdom, Italy, the United States, Canada, and Japan—with smaller models of regional economic groups—the smaller developed countries, OPEC, and non-OPEC LDCs. The centrally planned economies are represented by trade-flow equations. Because the model links the economies through the trade sector, it captures both the direct impact of shifts in trade with the United States and the indirect impact of shifts in Big Four trade with each other and the rest of the world. The LPIM does not fully model capital flows; so the responses of these economies to changes in their wealth are not completely captured.

We used the model to try to isolate the effect of the strong dollar from other factors that influence trade patterns, such as the US economic recovery. To estimate the impact, we first ran a baseline simulation for the 1980-84 period incorporating the exchange rate changes that actually occurred. We then ran a second simulation holding real exchange rates constant—that is, the nominal exchange rates were allowed to vary just enough to offset inflation differentials. More specifically, because we wanted to isolate the dollar's impact on each of the Big Four West European countries individually, we held the real dollar exchange rate constant against the Big Four on a weighted average basis, while allowing real exchange rates within the Big Four to vary as they actually did in the real world. The differences between the results generated by the two simulations measure the impact of the dollar's real exchange rate appreciation.

We believe, however, that the negative impact on Western Europe of these capital flows is relatively small. These flows presumably influence the West European economies by raising interest rates—something that our model can deal with—but do so to an extent that cannot be measured in isolation from other factors. Although real interest rates in Western Europe are unusually high by past standards, in our judgment this is at least as much due to restrictive domestic policies followed in an effort to bring inflation under control. Even if we make the extreme assumption that capital outflows caused West European real interest rates to rise 3 percentage points—real interest rates were on average 3 percentage points higher in the 1981-84 period than in 1980—less than half of the dollar's positive trade-related effects on GNP is eliminated. That is, West European GNP in 1984 is still 2.2 percent higher than it would have been if the dollar had remained at its 1980 real level (see table 3).

Table 3
Big Four: Impact of Dollar Appreciation and a 3-Percentage-Point Increase in Real Interest Rates

Percent change from baseline simulation

	1981	1982	1983	1984
GNP	−0.3	NEGL	0.6	2.2
Private consumption	−1.2	−1.4	−0.9	0.3
Investment	−2.1	−3.1	−3.0	−1.1
Exports of goods and services	NEGL	−0.8	−1.2	0.6
Imports of goods and services	−3.1	−5.8	−7.2	−6.8
Price level (GNP deflator)	1.0	3.8	7.0	10.5

Although the rise in the dollar clearly has increased LDC debt service costs in terms of other currencies, the problem has not led to a significant reduction in imports from Western Europe. According to the Federal Reserve Bank of New York, had the LDCs borrowed in 1979-82 the same mix of currencies as denominates their trade—instead of using dollars almost exclusively—they would have saved $30 billion in debt repayments. Most of the resulting cutbacks in LDC imports, however, have come at US expense because major US trading partners among the

LDCs—Mexico, Brazil, and Venezuela among others—have imposed the stiffest austerity programs. Among trading partner groups, the West Europeans registered their largest improvement in trade during 1980-83 with the LDCs, with their deficit plummeting from $55.1 billion to $9.7 billion; the deficit apparently increased slightly in 1984. In real terms, West European exports to LDCs were 7.5 percent higher in 1983 than in 1980, while US exports plunged 20.3 percent; much of the gain came from trade with oil exporters who found that their oil revenues could buy more in Western Europe than in the United States.

Impact of Future Dollar Movements

We believe the West Europeans would encounter more problems if the dollar declines than they would if the dollar stabilizes or appreciates further. A drop in the dollar would affect Western Europe negatively by putting strain on the EMS and by causing a slowdown in GNP growth because of worsened trade competitiveness. These problems—particularly the likelihood of an EMS realignment crisis—would be worse if the dollar depreciates rapidly because this would allow less time for the West Europeans to adapt to the new situation.

If the Dollar Weakens

Depreciation of the US dollar would create pressure for a realignment of EMS parities. In one sense, such a realignment is already overdue because of the inflation differentials existing between the EMS countries. Since the last realignment two years ago, West German prices have risen only 5 percent, while French and Italian prices have risen about 16 and 22 percent, respectively. A weakening of the dollar would cause these price differences to be reflected in exchange rate movements—a development that has been blocked by the rising dollar and the shift away from the mark as a store of value.

If the dollar drops, capital likely would flow much faster into West Germany than into other EC countries, thus causing the mark to appreciate against other EMS currencies. The French franc would come under particularly strong pressure because:

- Many international economists believe that the West German economy is more robust than the French economy; West German GNP growth is expected to grow almost 3 percent in 1985, as compared to forecasts of 2-percent growth in France.

- Widespread expectation that the mark will appreciate more than the franc against the dollar encourages early placement of funds in marks—in effect, a self-fulfilling prophecy. 25X1

- The West German aversion to capital controls reassures investors that they will be able to switch back to dollars or another currency if the mark starts to weaken. 25X1

Past EMS realignments have usually turned into crises, and the next one probably will be no exception. As in the past, the dispute likely will center on the relative changes required for the mark and the franc. Paris will argue for a substantial revaluation of the mark vis-a-vis all EMS currencies while Bonn will hold that more of the adjustment should be in the form of a franc devaluation. In an EMS crisis, the 25X1
West Germans would also argue—as they have consistently in the past—that other EMS members should adopt economic policies in line with those of West Germany; in press interviews, Bundesbank President Poehl has categorically rejected more inflationary West German monetary policies as a way of maintaining EMS parities. 25X1

In an attempt to wring concessions from the West Germans, the French could threaten to withdraw 25X1
from the EMS, as French Finance Minister Delors said they would during the last realignment in March 1983.

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If the West Germans called their bluff and speculation against the franc were severe, however, the French might carry out their threat. The more rapid the dollar's decline, the greater the strain on the EMS is likely to be because the member governments will have less time to work out a compromise before being forced to act.

A depreciation of the dollar would benefit the West Europeans by reducing the price of imports, thus slowing inflation. Our analysis with the LPIM shows that a one-time 30-percent depreciation of the dollar against all West European currencies would cause inflation in the Big Four to drop 1.0 percentage point in the first year following the depreciation; after four years the price level would be 9 percent lower than if real exchange rates had remained constant.

The improvement in inflation, however, would be offset by slower economic growth that would occur because the weaker dollar would reduce West European competitiveness vis-a-vis the United States. Although the main negative effect would fall on exports, consumption and investment also would suffer. In the first year following the hypothesized 30-percent dollar depreciation, Big Four GNP would be reduced almost 1 percent. After four years, GNP would be almost 3 percent lower than if real exchange rates had remained constant, (see inset and table 4). If the dollar were to depreciate 30 percent over a longer period, our model indicates that the results for GNP growth and inflation would be similar once the dollar stabilizes at the lower level. We believe, however, that with a longer adjustment period, the West European economies would be better able to adapt to changes in competitiveness than indicated by the LPIM. Moreover, West European governments probably would implement policies to counter the negative effects of the falling dollar. The impact on the EMS also would be less dramatic because EMS members would have more time to adjust, thus making realignment negotiations less contentious.

If the Dollar Strengthens

If the dollar rises from its present level, we believe the West European economies would continue to reap some net economic benefits. As in 1980-84, an appreciating dollar would improve international price competitiveness, boost real GNP growth, and help stabilize the EMS—albeit while generating some additional inflation. A strong dollar, caused by a continuing net flow of capital from Western Europe to the United States, would also place upward pressure on West European interest rates, thereby holding investment in Western Europe below what it otherwise would be. Nonetheless, we believe that increased exports would continue to have a greater positive influence on investment than the negative impact of higher interest rates due to capital outflows.

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Methodology for Estimating the Impact of a 30-Percent Devaluation of the Dollar

To estimate the impact of a weaker dollar, we ran a simulation on the LPIM assuming an arbitrary 30-percent drop in the US dollar's exchange rate against all EMS currencies from its 1984 level, with real exchange rates remaining constant afterward. All other independent variables were unchanged. We compared the simulation results for GNP, trade, and inflation with a baseline simulation that kept the real exchange rate for the US dollar at its 1984 level. The differences between the simulations represent the estimated impact of a 30-percent fall in the dollar's value. The results capture the direct effects of decreased exports to the United States and the indirect impact of decreased exports to the rest of the world because of increased US competitiveness.

The simulation results presented in tables 3 and 5 should not be compared directly. Table 3 uses the historical appreciation of the dollar against all four major West European currencies; the appreciation was uneven over time and against each country's currency. Table 5, on the other hand, assumes a 30-percent depreciation of the dollar against each of the four currencies at the start of the simulated period, with the real value of the dollar thereafter remaining constant.

Implications

Despite past criticism of the strong dollar, the West Europeans would have more difficulty coping with

Table 4
Big Four: Impact of a 30-Percent Depreciation of the Dollar

Percent change from baseline simulation

	First Year	Second Year	Third Year	Fourth Year
GNP	−0.9	−1.4	−2.0	−2.7
Private consumption	0.3	0.1	−0.7	−1.6
Investment	−1.4	−1.6	−1.7	−2.0
Exports of goods and services	−3.0	−3.2	−3.8	−4.3
Imports of goods and services	0.4	0.3	−0.1	−0.8
Price level (GNP deflator)	−1.0	−3.6	−6.3	−8.9

depreciation of the dollar than with its further appreciation. A fall in the dollar's value—particularly if rapid—would increase US–West European tensions as well as strain relations among the West European governments. On the other hand, a weaker dollar would allow West European defense budgets to go further in buying US equipment and petroleum. Continued strength of the dollar would have less significant implications, unless it is seen as triggering protectionist moves by the United States. Regardless of what happens, the West Europeans will hold the US Government responsible for both the movements in the dollar's value and the consequences, real or alleged.

US–West European Relations

If a fall in the dollar places severe pressures on the EMS, EC governments almost certainly would blame Washington in an effort to minimize their responsibility in the eyes of the public. Paris in particular likely would maintain that troubles in the EMS stemmed from US economic mismanagement and not from differences between French and West German economic performance. Because of the negative impact of a depreciating dollar on West European trade and employment, the European Community probably would become even less inclined to compromise on trade issues such as US proposals for widening GATT rules to cover trade in agricultural products and services.

If the dollar stays strong—thereby helping to stabilize the EMS—EC governments probably will maintain their present attitude toward US economic policies. French demands for an international monetary conference might even diminish if the dollar stabilizes at its present high level. Paris's main reason for wanting such a conference is to set up a mechanism to reduce currency fluctuations—not to calculate a specific rate for the dollar. Continued strength in the dollar likely would also make the West Europeans less confrontational on some trade issues—such as US proposals for a new round of multilateral trade negotiations—because they would still benefit from a price advantage over US producers. 25X1

Intra–West European Relations 25X1

Another EMS crisis, precipitated by a rapid depreciation of the dollar, would be a severe blow to the EC. The European Community as an institution would appear less effective in the eyes of the West European public, and indifference toward the Community would grow, encouraging more nationalistic approaches to common economic issues. In the United Kingdom and Denmark, where EC membership is opposed by substantial minorities, pressure for withdrawal from the Community probably would grow in light of another example of the Community's inability to take successful action on an important issue. 25X1

Depreciation of the dollar also would make incorporating the British pound into the EMS intervention mechanism more difficult. The British Government 25X1
decided to stay out of the mechanism because London feared a repetition of its costly—and ultimately futile—effort to maintain the pound's exchange rate during the mid-1970s. In early 1984, however, French President Mitterrand publicly urged London to join the intervention system, and the *Financial Times* has reported that the British Treasury is studying the proposal, although Prime Minister Margaret Thatcher has taken no action. A weak dollar probably would push up the pound's value against the French franc for the same reasons that the West German mark would go up: British GNP growth probably will exceed that of France, British inflation is low, and

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London dislikes capital controls. Exchange rate volatility—this time caused by the dollar—could become the principal reason for the pound remaining outside the intervention mechanism.

In our view, continued strength of the dollar would have little effect on intra–West European relations. Eventually, the Italians, whose currency recently has appreciated in real terms vis-a-vis its trading partners, probably would ask for a realignment to regain price competitiveness within the European Community. Because the EMS parity for the Italian lira likely would be under no pressure from a rising dollar, such a request could be considered on its merits without the distraction of an exchange rate crisis.

Economic Policies

A drop in the dollar almost certainly would cause more of an economic policy response by the West Europeans than would a rise in the dollar. A weakening dollar probably would encourage the West Europeans to relax monetary policy in an attempt to lower interest rates and thus prop up economic growth. According to our estimates, real interest rates in Western Europe would have to fall more than 4 percentage points in order to counterbalance the negative effects on West European growth of a 30-percent decline in the real exchange rate of the dollar. We have no indication, however, that the West Europeans have drawn up plans for lowering interest rates in the event the dollar drops or that they have analyzed how much of an interest rate decline would be needed to offset the trade effects of a weaker dollar.

Given the current economic climate in Western Europe, most governments will avoid major economic policy shifts to defend their exchange rates against upward movements of the dollar. Indeed, most West European governments recognize that a strong dollar keeps their economies' products more competitive. Raising interest rates in the face of slow growth, rising unemployment, and already high real interest rates almost certainly would be regarded as unattractive by most West Europeans. Except perhaps in the United Kingdom, only marginal adjustments to economic policy probably would be made; the West Germans and the French, for example, are repealing tax withholding on interest on foreign-owned government bonds to make their bonds—and their currencies—more attractive without raising interest rates.

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Defense Budgets

Changes in the relative value of the dollar influences real defense spending in Western Europe. Although a depreciating dollar would enable West Europeans to buy more defense goods priced in dollars—with no increase in national currency spending—a rising dollar would have the opposite effect. Over the past several years, the appreciating dollar has impaired the defense capabilities of West European NATO members by reducing the purchasing power of defense budgets for equipment, petroleum, and training. To deal with higher costs in national currencies, West European governments have:

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- Canceled US purchases and bought from West European suppliers.
- Cut the size of orders.
- Stretched out procurement over a longer period.
- Pressured US manufacturers to make more favorable offers, which usually involve easier credit or more sizable offset agreements.
- Cut training and troop levels to reduce pressure on equipment purchases.

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Nonetheless, even though a fall in the dollar would reduce defense costs, it is not likely to counterbalance political pressure for trimming defense spending in Western Europe. Moreover, because of the negative effects on trade and employment from their appreciating currencies, the West Europeans would press even harder for US purchases of their defense equipment and for mutual efforts to right the military trade imbalance.

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